Appendix A

COMMENTS OF DAVID LAX AND PAUL LEVY

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We have been asked by Massachusetts Electric Company to address certain aspects of the Department's May 1 Order and proposed rules. In particular, we address the Department's desire to promote the divestiture of generating assets and offer our suggestions to improve the workability of the Department's proposals in this area.

Based on the Department's draft order, it appears that the desire to promote a divestiture of generating assets is prompted by two concerns.

First, the Department appears to want to employ some kind of market mechanism to establish the value of these assets as a way of quantifying the level of stranded costs that will be collected through non-bypassable access charges. Compared to other likely methods in which experts develop and apply models based upon certain assumptions, we agree that a properly structured market test can be very useful in this regard.

Second, the Order implies that the Department has a desire to reduce the potential market power of integrated utility companies after retail wheeling is permitted. Divestiture is apparently viewed as a mechanism for accomplishing this goal. We believe that the testimony filed by Richard Gilbert on behalf of Mass. Electric and the report prepared by Tabors, Caramanis for the Attorney General conclusively establish that the generating market in New England is highly likely to be quite competitive. No party, in our view, has presented a persuasive case that changes in corporate ownership of generating assets are needed to secure the benefits of competition to Massachusetts customers.

Given the Department's direction on this matter, however, we propose to offer the Department advice as to how to implement its proposed policy in a manner which will accomplish its overall goals more effectively. In particular, we offer principles and information on this topic that can inform the Department's decision-making process. We contend, further, that the approach set forth by the Department in its Order is unworkable and will produce untoward results, both for customers and utilities.

There are two principles that form the basis for our recommendations: (1) If the Department seeks to influence the utilities to undertake some sort of market-based valuation, it should create incentives to do so that are clear and that are not changed after the fact. (2) There are a variety of possible means of obtaining a market valuation, and it is impossible to know today which one will produce societally optimal results for any given utility at some time in the future. Accordingly, the Department ought to identify a variety of pre-approved methods that could be used by utilities to accomplish this.

The context for these principles is that the Department is about to undertake a major structural reform in the regulation of utilities under its supervision. After decades of cost of service regulation of integrated utilities, the Department proposes to unbundle the components of electricity supply and design a regulatory scheme that will permit a smooth transition to deregulation in those parts of the industry that are sufficiently competitive and to performance based regulation in those parts of the industry that maintain their natural monopoly characteristics. In a situation like this, the end result of the transition may seem more clear than the steps of the transition itself. It is rather easy, for example, to visualize the final scenario: An electricity industry in which service offerings are unbundled, where customers have a choice of suppliers, and where the market functions by bringing together willing suppliers and informed buyers and sellers in a more efficient manner than was possible under regulation. Yet, the steps chosen along the way by the Department to influence the transition will affect the degree to which the Department's long-term vision of the industry is effectively implemented.

We make this observation particularly with regard to the stranded cost/divestiture issue. In a restructuring effort of this sort, the Department has to decide how much it will regulate the direction of the restructuring process (by providing guidance and incentives) versus how much it regulates the result of the restructuring process (by insisting on deciding the final allocation of costs between utilities and customers). As we shall discuss, the more the Department encourages utilities to rely on market forces to quantify the rules of the transition, the less control it will have over the result. To the extent the Department attempts to regulate the result, the more it will impair the incentives it has put in place for utilities to respond to market forces.

We return now to our first principle: If the Department seeks to influence the utilities to undertake some sort of market-based valuation, it should create incentives to do so that are clear and that are not changed after the fact.

Before expanding on this principle, we must first take note of a general approach set forth by the Department that is extremely troubling. The Order implies that a utility that chooses not to divest should receive a smaller percentage of its net nonmitigable stranded costs than a company that does divest (Order, p. 56). In setting forth possible mechanisms for accomplishing this philosophy, the Department seems to want to adopt a punitive approach to the recovery of costs associated with the commitments that utilities have made in fulfillment of their public service obligations. A company choosing not to divest would not receive the full amount of its net nonmitigable stranded costs, contrary to the earlier principles adopted by the Department. Yet a company choosing to divest would likewise receive only some, potentially higher, percentage of its net nonmitigable stranded costs (Order, p. 57). As written, this section directly violates the Department's first transition principle, that it intends to honor existing commitments. It is clearly unfair.

Thus, as the Order now stands, the Department has created an untenable position for utilities that are not sure whether to divest their generating assets. They are left with the two options outlined above. One option starts with uncertain regulatory treatment and ends up with the potential for a court challenge. The second option is to engage in a market test of valuing assets, followed by uncertain regulatory treatment and ultimately a court challenge if the utility is not satisfied with the regulatory treatment it receives. Both paths converge to the same end point.

As a result, the Department has not given such utilities an incentive to go along the market valuation route.

We believe that the nature of the incentives to encourage a market-based valuation should be clearly stated at the outset. In the absence of such clarity, the various incremental decisions made by utility owners of generating capacity will be inappropriately influenced by the uncertain regulatory treatment. As we explain below, the minimum fair result should be a reasonable opportunity to recover net, nonmitigatable stranded costs whether or not a sale occurs. An incentive, if appropriate, should provide some ancillary benefit such as accelerated recovery of stranded costs or a higher than typical equity return on the unamortized investment balance. In any event, a reconciliation in later years following a divestiture is inappropriate. The market valuation at the time of the sale takes into account whatever mitigation measures might have been employed to reduce the level of stranded costs.

While some people might be concerned that the market will produce the wrong valuation and that there will be a need for a reconciliation in later years, we would argue the contrary. Such an interpretation implies a fundamental misunderstanding of the purpose of a market valuation and misses a critical point: Having created the incentives for and having prescribed a market-based mechanism for valuing the assets, the Department should not also judge the outcomes produced by the market.

We reach this conclusion for two reasons:

1. Capital markets have been shown to provide efficient valuations of corporate assets that rapidly assimilate all the publicly available information regarding the value of the assets. Because market valuations typically combine the analyses and perceptions of a large number of potential investors, market-based valuations are likely to be substantially more accurate on average than those of any particular set of experts. In general, they provide the best available estimates of the assets' value. In general, the market prices are unbiased and, with some exceptions, are

equally likely to be high as to be low. The extremely low number of professional money managers who are able to achieve long-term returns in excess of the stock market speaks to the effectiveness and efficiency of market-based valuation mechanisms; on average the stock market does a more accurate job of predicting assets' values. A true-up mechanism, in which shortly after the divestiture the Department shades down the recoverable costs if the market price of the divested generating assets turns out to be lower than the Department's assessment of their value, ignores the efficiency of the capital markets and substitutes the Department's own subjective judgments for a more neutral and likely more accurate estimate of the assets' value.

2. The Department's announced plan to reduce the stranded cost estimate from that produced by a market valuation unintentionally creates an incentives for behavior that runs counter to the Department's desires. This can be illustrated as follows:

A utility that divests can do nothing after the Department’s true-up is revealed. A utility that has not divested can make ex post mitigation decisions and may feel it will be able to recover a higher proportion of its stranded costs by virtue of these ex post mitigation decisions. To the extent that utilities think that they will make better decisions after, rather than before, they hear the proportion by which the Department has shaded down their stranded costs, the utilities may choose to forgo divestiture or defer it until after the true-up.

Related to this point is the idea that a utility that might prefer not to divest is given no real incentive to consider market valuation or divestiture. If there is uncertainty about the level of the true-up, or if the announced level of the true-up is too low, the utility might prefer to avoid engaging in the market valuation and rather take its chance on the legal system’s supporting its right to recover the full amount of its stranded costs.

In summary, to encourage utilities that would not otherwise choose to adopt the direction the Department prefers, i.e., a market valuation of assets, the Department needs to establish that there is certainty in the level of cost recovery and that the level of cost recovery itself is sufficiently high to prompt the actions it desires. Relying on an uncertain, punitive action will not prompt the behavior the Department seeks.

We turn now to our second principle: There are a variety of possible divestiture mechanisms, and it is impossible to know today which one will produce societally optimal results for any given utility at some time in the future. Accordingly, the Department ought to identify a variety of pre-approved methods that could be used by utilities to divest assets. Some possible methods include the following:

1. Transfer of the entire generating company as a spin-off to existing shareholders.
2. Transfer of a portion of the stock of the generating company by initial public offering or spin-off.
3. Sale of individual assets or groups of assets phased over time.

Considerations that the Department should use in pre-approving valuation methods proposed by utilities include:

1. Is it likely to produce a valuation that reflects a market value of the assets in question?
2. If the transaction is phased over time, does the phasing impair the operation of the utility and reduce incentives for operational improvements and thereby increase the stranded cost charges that ratepayers will ultimately pay?
3. Can it be carried out in the time period the Department wishes so that the benefits of the divestiture will enure to current ratepayers?
4. Does it avoid adverse tax consequences that reduce the value of the transaction to ratepayers?